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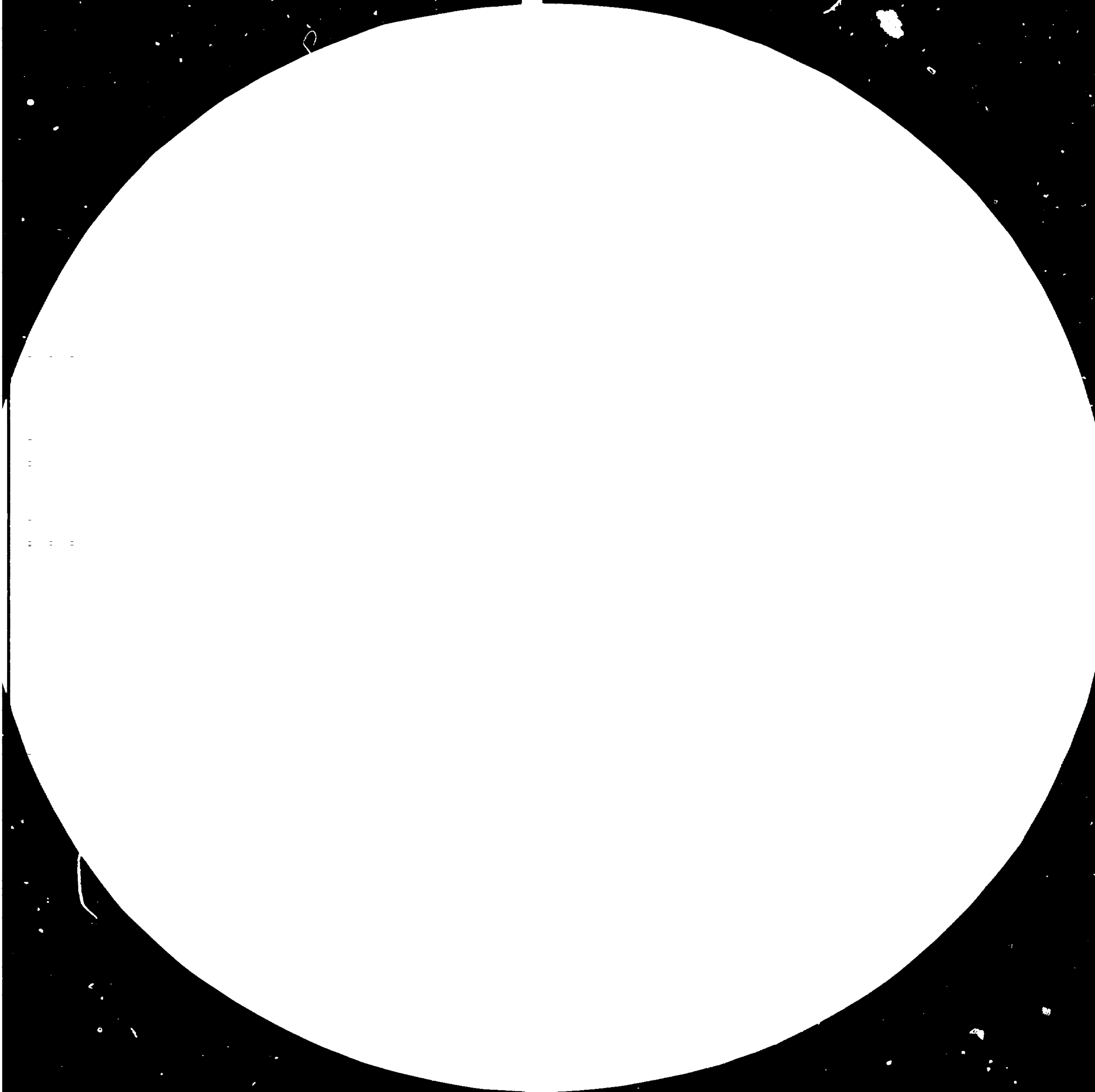

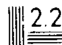

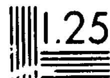

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SUGGESTED ISSUE NO. 1: THE NATURE AND CONDITIONS OF ACCESS TO INTERNATIONAL INDUSTRIAL FINANCING IN DEVELOPING COUNTRIES*

prepared by

the secretariat of UNIDO

* This is one of three issues suggested by the UNIDO secretariat; the participants are expected to consider these and other issues they may suggest and advise on the selection of priority issues.

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Introduction

The use of external funds for industrial investment has become increasingly important, with finance being provided mainly from the commercial banks, i.e. the syndicated Eurocredit market, the export credit agencies of the developed countries, and to a lesser extent from the ordinary resources of the multilateral finance agencies.

Country risk

The use of external finance for industrial development in developing countries takes place either in the form of project finance or in the form of resource transfers which support balance of payment deficits (either by the multilateral finance agencies or by the transnational commercial banks). Only in the case of project finance does it appear that the decision to provide credit is preceded by some type of evaluation by foreign lenders, more or less rigorous, of the expected viability of projects. However, in virtually all cases it would seem that lending decisions depend on the evaluation of what has come to be called "country risk", i.e. that risk which can be attributed to events beyond the immediate control of a project entity but which is influenced by the Government of the country in which the project is placed. The fundamental problem is that the external financing of industrial projects should not be seen in isolation from the country in which they are located. Project risk may be considered, formally and technically, separate from country risk; however, should not both types of risks be considered by borrowers? Some lenders may be concerned only about country risk, relying instead on implicit or explicit country guarantees, and saving on expensive lending overhead costs.

It has been estimated that in 1979 exports to the non OPEC developing countries amounted to about $180 billion or 34 per cent of OECD exports. What will be the consequences for exporters of capital goods when developing countries reduce their capital goods purchases because of shortage of finance on appropriate terms?

How can country and project risks be reduced? Alternatively, are there unexplored possibilities for the sharing of country risk, in recognition that both purchasers and vendors benefit from such transactions?

Market access

Many observers have questioned the concentration, by the Eurocredit market, of very heavy lending to about twelve developing countries. It would seem that in a global economy characterized by highly fluctuating interest and exchange rates, such a policy carries with it serious risks both for these large borrowers and for the international financial system. It has been estimated that the aggregate deficit of twelve major borrowers will be $45 billion in 1981, with the import cover provided by their international reserves expected to decline to about three months at end 1981 from five months in the 1976-1979 period. Can the international banking system finance these deficits? Should it?

With respect to the poorest group of developing countries (i.e. below $300 per capita), the Eurocredit markets have for the most part been irrelevant; in the post 1973 period, these countries have had to cut back sharply on their imports. Even if these countries had been able to borrow, would they have been wise to do so on the terms and conditions prevailing in this market? Should poor countries which import only necessities risk having to compress their imports of necessities to service Eurocredit debt? It should be noted that not only is concessional finance limited, but it is even more limited for use in industrial development: fashion has changed among concessional lenders for financing industrial projects. How can the poorer countries

finance their industrial development? Is it correct to assume that feasible projects in these most disadvantaged countries can attract finance on concessional terms? Alternatively, can the assumption be made that there are in fact only very few feasible projects in these countries, and that these disadvantaged countries should remain raw material producers?

Project risk

In considering "project risk", it is normal to direct attention to the project entity, i.e. that entity with its own financial statements, financial control etc.

Since the degree of fluctuation to which the "cut-off" project discount rate, i.e. the minimum return for financial viability, is subjected critically depends on the source of external financing, i.e. Eurocredit financing with floating interest rates and Eurocredit or multilateral agency financing with funds made available in currencies which lead to foreign exchange exposure/risk to particular industrial projects, these influences have the major consequence of determining not only resource allocation as between different projects, but also indirectly the technological choice and design of these projects. Thus, the already complex problems associated with the financial and economic evaluation of projects are further compounded by the additional problems of forecasting both cyclical and future trends in exchange rates and interest rates during the amortization period of projects. Is it not the case that an industrial project entity may be highly attractive, but the available external financial environment, i.e. maturities etc., makes the project financially unattractive? Alternatively, where these risks are assumed by the developing country's Government, may not the hazard of a "debt trap" become acute?

Among the questions arising from this environment are the following:

(a) Should developing countries significantly decrease their foreign financing exposure? Would this not lead to sub-optimal project and technological choice as well as possibly suboptimal signals to planners and policy makers? Would these planners and policy makers not be well advised to adopt more inward looking development strategies and plans?

(b) Should there not be a preference for quick maturing industrial projects rather than basic industry which tends to have longer gestation periods, given the maturity structure and risks of currently available finance? What would be the consequence of this for developing countries wishing to develop?

(c) Where finance and procurement are tied, i.e. loosely for the multilateral finance agencies, closely for the export credit agencies, should these finance agencies adopt measures to ensure sellers' prices (of goods and services) are "fair"? What measures?

<u>Future access and improved conditions in the supply of external finance to industry</u>

It may be the case that the commercial banks cannot play as large a relative role in meeting the borrowing requirements of those developing countries with access to these funds as was the case after the initial round of oil price adjustments in 1973/1974, because of prudential bank concerns with regard to country risk and country exposure limits. These developing countries are perceived to be in a more difficult position because of:

(a) the sharp increase in their external debt in recent years;

(b) the servicing of this debt based as it is on floating interest and exchange rates and short maturities may remain onerous in the light of the new tight money policies pursued in some of the major lending countries;

(c) the price of oil is envisaged not to fall in real terms;

(d) many developing country borrowers will have great difficulty in adjusting to the price rises of their other imports, in particular capital equipment imports;

(e) exporting to the industrialized countries may become more difficult because of persistent recession and the increase of protectionism, and this will increase the need to borrow externally.

The requirements of this group of developing countries for external finance are therefore estimated to remain high:

(a) for balance of payments financing;

(b) for industrial and energy related investment consequential upon the increase in the relative price of energy; and

(c) in an attempt to maintain their past rate of industrial growth, all in circumstances where their underlying debt service capacity may be seriously impaired.

Will a greater share of external financing requirements, including financing for industrial investment, be met through existing institutional arrangements or will new multilateral financing arrangements be required? Is the current balancing of powers and responsibilities among official and private lenders and Governments adequate and effective in achieving orderly arrangements for financing and adjustment? Would the impact on the commercial banking system of the failure of one large borrower (sovereign or private) be contained?

Most financing agencies (multilateral/bilateral/commercial) still have mechanisms designed to deal with the well recognized difficulties of the 1950s and 1960s arising from declines in commodity prices, whereas it seems that the necessity of changing to different types of industrial technology or to different industrial development strategies, i.e. structural adjustment at the microeconomic and macroeconomic levels, might call for different financing arrangements. Moreover, when the world economy is subjected to the significant and persistent disequilibria

together with the wide swings in interest and exchange rates seen over the recent years, individual developing countries find it far more difficult to adjust than in a stable world economy. Are there needs for revisions and modifications in the procedures and mode of lending operations of the financing institutions?